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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET Letter 203 (December 10) discussed the unusual pattern of the Industrial Average -- as viewed on a semi-logarithmic chart. Attention was directed to the "rounding over in the price structure and the gradual loss of upside momentum." At the same time it was pointed out that the Rails were putting on a much more impressive performance than the senior Average.

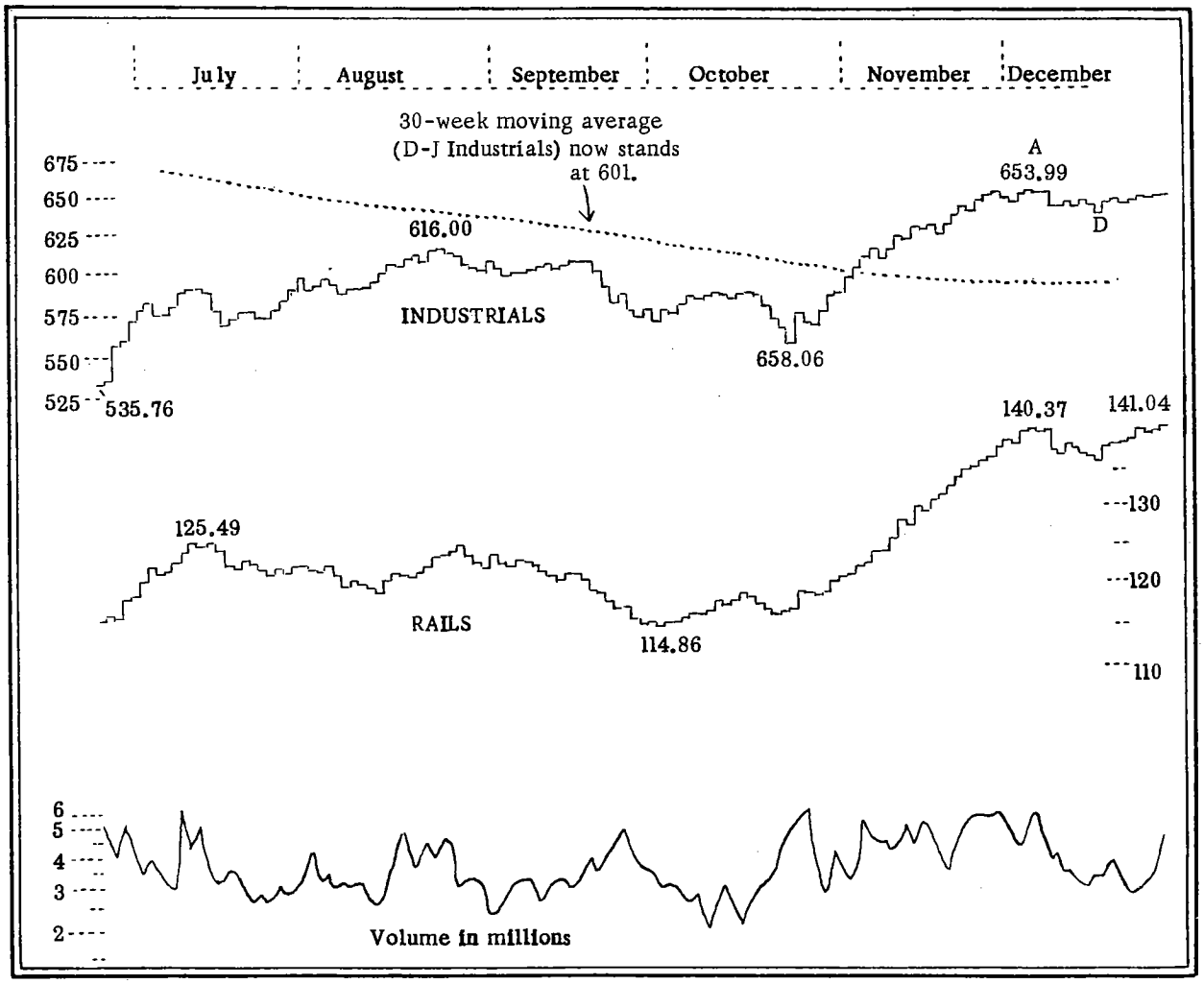
The market picture, as set forth in Letter 203, is more obvious now. For 26 trading days (since November 23), Industrials have been fluctuating within a narrow 2% range bordered by 653.99 on the upside and 640.19 on the downside.

On December 26 the Rail Average bettered its preceding (December 5) peak, rising to a new recovery high of 140.60. Following a slight dip, Rails again (on December 31) pushed to a new recovery high. The successive Rail highs have not (so far) been confirmed by the Industrial Average.

Under Dow Theory, a movement of one Average unconfirmed by the other is meaningless (and often deceptive). As far as the new Rail highs are concerned, they possess no forecasting value.

There is no "time limit" on the confirmation principle; the non-confirming Average may confirm in a day, a week or a month. In general, however, the closer the time span within which the two Averages confirm, the better the forecasting value.

It is of interest that both Averages bettered their August highs simultaneously (on November 9). Eleven trading days later (November 27) the advance-decline ratio bettered its own August peak. Thus all indicators were in gear on the upside. Following the November 9 signal, Industrials rose 6% to a 653.99 peak.



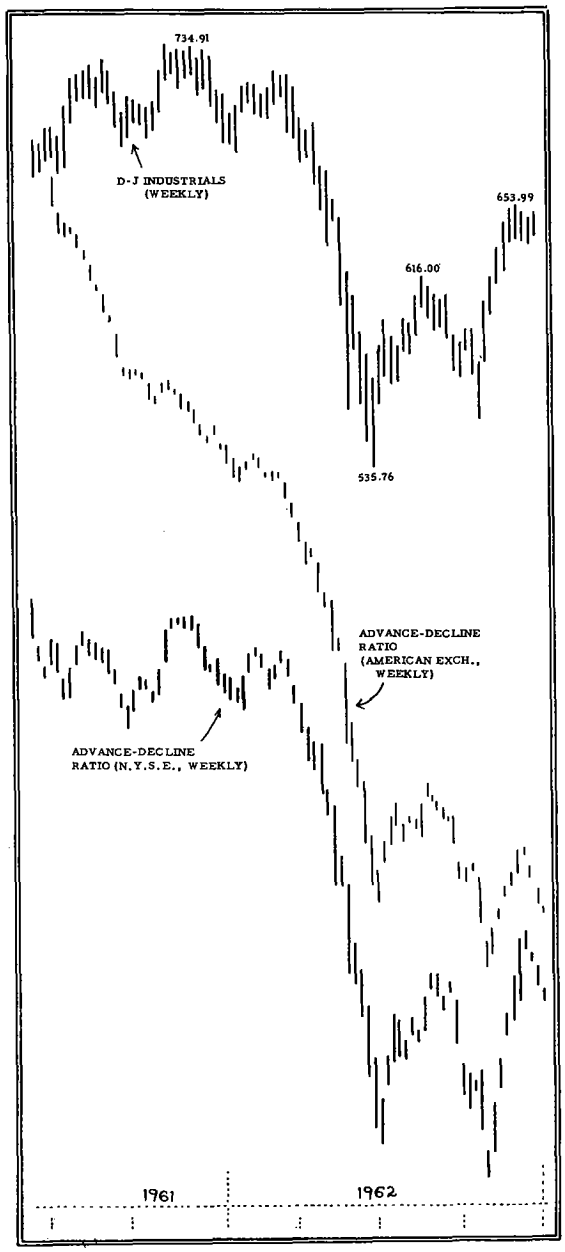
A great many analysts took the November 9 joint penetration as the signal for a "new bull market" (this writer was not among them). In the face of the rising market, leading economists executed an "about-face" and predicted that 1963 was going to be a good year (this writer was and is sceptical). Much is now being made of favorable automobile sales, department store sales, construction awards, etc., and we are told that these statistics add up to a prosperous 1963. Perhaps, but I would rather let the market do the talking.

CONCLUSION: For the first time on the rise since October, the Averages and the A-D ratio are "out of gear." As of this writing, Rails have risen to new recovery highs, Industrials have not confirmed, and the advance-decline ratio has sunk back to the vicinity of its August, 1962 peak (at which time Industrials were 616.00).

There is little point at this juncture in attempting to "outguess" the market. If Industrials now rally to a recovery high, it remains to be seen whether the A-D ratio can confirm. An Industrial recovery high (above 653.99) unconfirmed by a new high on the A-D ratio would provide the technical formula for a reaction. Over the past four weeks, the majority of stocks (as represented by the A-D ratio) have been subject to more selling pressure than has the Industrial Average (see chart on page 2). When this has occurred in the past (particularly when it has occurred in December), the situation has usually resolved itself into a lengthy first-quarter stalemate or a January reaction.

ADVANCE-DECLINE RATIOS Recent Letters have concerned themselves largely with "how" and "why" -- the implcations of the violent 1962 crash and the equally violent recovery. As opposed to "why", this Letter will attempt to show what actually happened in 1962 -- what the Averages, the bond Averages and the A-D ratio have done.

I include a chart which shows the weekly range of the Industrial Average together with the weekly high and low range of the advance-decline ratios on both the New York and American Exchanges.



The A-D ratio (representative of the advancing or declining tendencies of all stocks) on the New York Stock Exchange touched a high in May, 1961. Following this, Industrials rose to two successive all-time peaks (September and December). These highs were not confirmed by the A-D ratio -- a warning of things to come. The history of the price-breadth relationship shows that it is not enough for the thirty Dow stocks to push higher; that rise must be confirmed by a rising tendency in the majority of listed stocks (i.e., the A-D ratio). Or put another way, "What is good for General Motors may be good for the country", but if it is -- then the rest of the country's corporations should reflect it by a consistent rise in the prices of their equities.

During the 1961 period, the A-D ratio on the more speculative American Exchange was flashing danger signals (see chart). The steady decline in the American's A-D ratio indicated that aggressive selling was taking place in the lesser-grade issues.

In early 1962 all price indicators got "in gear" on the downside. Industrials dropped 199 points (to a June low of 535.76), while both A-D ratios continued their descent to October, 1962. By any reckoning, the action of May and June, 1962, must be considered "crash-action" of the most violent kind.

The technical vacuum set up by the new (October) low on the A-D ratio unconfirmed by a new low on the Industrial Average touched off a rally which compared in upside violence with the downside violence of the May-June collapse. However, the time factor during the decline and the recovery is worth noting. The March-June decline in the A-D ratio (New York Exchange) continued unabated for 15 consecutive weeks. As such, it must go down as one of the great technical collapses of history (those who own the new A-D Ratio Albums might find it interesting to compare the 1962 decline with those of 1946, 1937 and 1929-32).

The rise from the October low carried the A-D ratio steadily higher for 6 consecutive weeks. The rise was interrupted on the week ending December 14 by a significant and sharp decline in the A-D ratio. In comparison, it is of interest that the rise in the A-D ratio from the 1960 lows continued without interruption for 24 consecutive weeks while the rise in the A-D ratio from 1958 to 1959 continued without an important interruption for 57 weeks.

In keeping with its dismal performance during 1961 and early 1962, the A-D ratio on the American Exchange has lagged badly during the late 1962 recovery. The American staged a 6-week recovery from the October low, then dropped off sharply over the past three weeks. As of this writing, the American A-D ratio is actually below the level of its June, 1962 crash low. Perhaps significantly, both A-D ratios are still below their low levels of two years ago (i.e., the October, 1960, lows).

CONCLUSION: Although the D-J Industrial Average has staged a strong recovery since the June, 1962 low, the mass of stocks (as measured by the A-D ratios) have not been able to match the performance of thirty of America's leading Industrial equities.

THE BOND MYSTERY Letter 204 contained a study of business (Barron's Business Index) and the Averages. Closely connected with this study is the relationship between business and bond prices.

Normally, a period of forthcoming business expansion means a period of rising (bank) discount rates, tightening money, and therefore (competitively) higher bond yields and lower bond prices. The arrows on the accompanying chart indicate the major turning points in Barron's Business Index (arrows pointing up indicate periods when Barron's Business Index turned up; arrows pointing down indicate periods when business turned down).

On the chart we see the Bond Indexes rising throughout the 1960 (business) recession period. The broad D-J 40 Bond Average continued higher until the first quarter of 1961. Barron's Treasury Bond Index recorded a high of 92.08 in August, 1960, then turned down. A second rally ensued, followed by a perfect "double top" on the Treasury Bond Index in May, 1961 (at 92.00). It is possible that the Treasury Index would have gone to a new high in early 1961 (along with the 40 Bond Average), but the Federal Reserve Board's "Operation Nudge" was inaugurated in February, 1961. This was an attempt (via manipulation) by the Fed to keep short-term interest rates high and thereby prevent further severe U.S. gold losses.

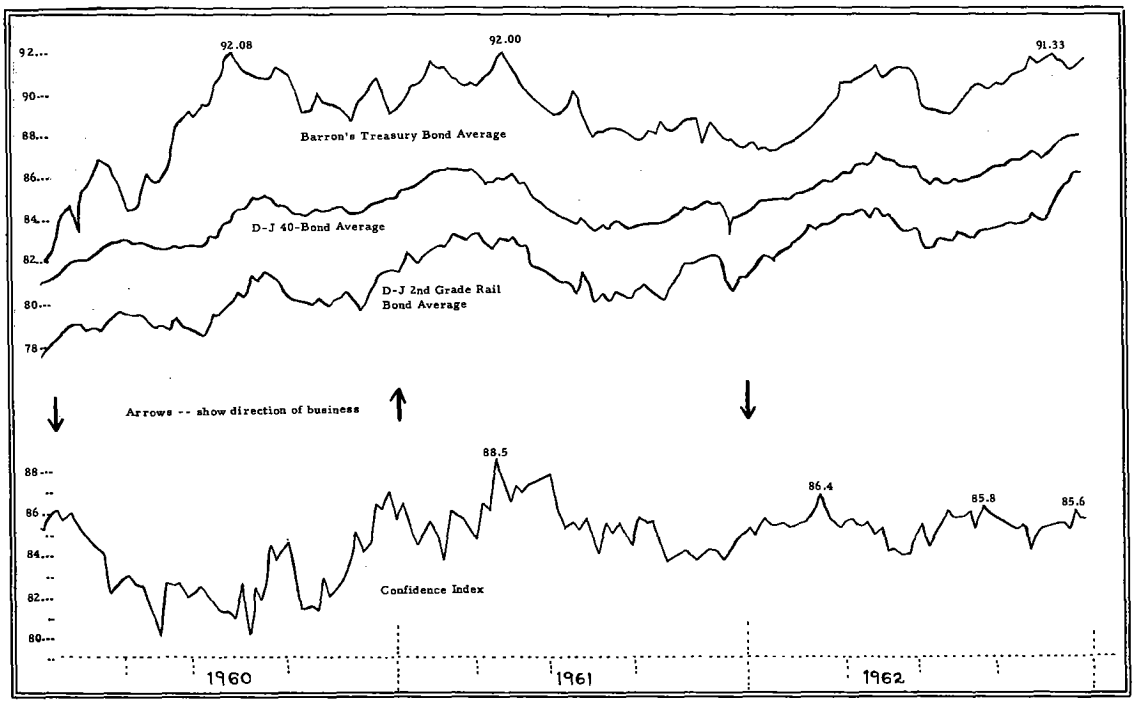
The recession ended in late 1960, and in early 1961 business turned up. In the face of an expanding economy the major bond averages reversed to the downside. The business recovery continued until December, 1961, at which time Barron's Business Index (see last Letter) struck a 1961 peak of 94.5.

In 1962 business again turned down, accompanied by a collapsing stock market. Against this action, the bond averages rose to new highs, and currently the representative 40-Bond Index is at its highest level since 1958. Barron's Treasury Bond Index has risen to within a point of its 1960-61 double top, but it has refused (as of this writing) to follow the 40-Bonds to a new high.

I feel that the total bond picture is now particularly significant. Contrary to the optimistic expectations of Washington economists, the balance of payments is now running at a rate of approximately 2 to 2 1/2 billion against the U.S. This adverse situation could mean a further outflow of gold at any time, and it could also mean that any forthcoming rise in business would be greeted by a Federal Reserve policy of higher interest rates (in an attempt to prevent further gold losses).

Conclusion: If business is to expand and interest rates are to rise in 1963, the major bond averages do not yet reflect such expectations on the part of bond-buyers. All three bond averages are now at or above preceding highs of the past four years.

A second interesting consideration is the ratio of the yields on Barron's 10 Highest Grade Bonds and the broad D-J 40-Bond Average (this ratio is known as the Confidence Index). When bond buyers are confident, they normally switch



funds into lower grade (higher interest-bearing) bonds, and this action is reflected in the movements of the Confidence Index.

As seen on the chart, the Confidence Index recorded a high of 88.5 in April, 1961. The next peak was touched in March, 1962 (at 86.4). A third high was established in August, 1962 (at 85.8). A recent minor peak was touched on November 29 at 85.6. Thus, up to the time of this writing there has been a long-term trend of declining tops or peaks in confidence on the part of bond-buyers. A concerted rise in the Confidence Index could change all this, but as of now no such thing has occurred. If the market is forecasting a period of expanding business next year, it has not (so far) been reflected in either the bond averages or the Confidence Index.

STOCKS Of 346 representative stocks which are watched with particular care at this office, 217 (63%) are holding above their 30-week moving average (no change from last week). Yet only 133 (38%) of these same stocks are above their August peaks (and this is a reflection of the lag in breadth).

Letter 202 noted that many stocks were forming giant triangles, and that it would be important to watch the direction of the eventual breakout from these patterns. As of this writing, the action referred to in Letter 202 continues.

Weekly charts below illustrate the great continuing triangle in IBM. A triangle structure implies that the forces of supply and demand are very evenly matched. Eventual penetration of the upper or lower trendlines will afford an important prediction as to the next major movement in IBM. Similar charts formations are shown in Owens-Illinois Glass, Aluminum Ltd., and San Diego Imperial (upper and lower triangle price limits appear on charts).

Two things might be learned from these patterns: (1) the longer the triangles continue without a breakout, the less the force of the final breakout. When a triangle works out to or near its apex, the potential force seems to have been spent. (2) the majority of issues have still not moved substantially away from their bases. If there is to be "a great upward movement resembling another 1958", most stocks have not yet started on their way. I would rather buy breakouts from large triangles and rectangles than chase abrupt reversals. Most of the large patterns which have formed (and the four charts on this page illustrate important patterns) have not yet broken out. When they do break, it will be important to see which way the final penetrations come.

LATE NOTES (Written Wednesday, Jan. 2, 2 P.M., N.Y. time): This morning Rails have risen to a new high while Industrials have dropped almost four points. Such divergence is often resolved in the direction of the first "in gear" movement (particularly if volume increases as the Averages move together).

Charts on this page courtesy of Traders Research, P. O. Box 2466, St. Louis 16, Missouri